



**Assessing the Impact of
Microenterprise Services (AIMS)**

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**THE ECONOMIC, POLICY,
AND REGULATORY ENVIRONMENT**

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TABLE OF CONTENTS

FOREWORDiii

EXECUTIVE SUMMARYv

I.	INTRODUCTION: IMPORTANCE OF THE PROGRAM ENVIRONMENT	1
II.	FORMS OF ENVIRONMENTAL INFLUENCE	5
A.	The Physical Environment	5
B.	Formal and Informal Institutions	6
C.	Economic Factors	9
1.	<u>Income and Wealth</u>	9
2.	<u>Inflation</u>	10
3.	<u>Market Structure</u>	10
D.	Government Policies and Regulations	11
1.	<u>Indirect Impacts through Effects on Microenterprises</u>	12
2.	<u>Direct Impacts on ME Programs</u>	16
E.	Conclusion	17
III.	DIFFERENTIAL EFFECTS OF POLICIES AND REGULATIONS	19
A.	By Scale of Enterprise	19
B.	By Household Income Level	21
C.	By Industry	22
D.	By Region	22
IV.	MAGNITUDE OF ENVIRONMENTAL IMPACTS	25
A.	Direct Effects of the Environment on ME Programs	25
B.	Environmental Factors that Affect ME Programs through their Effects on Microenterprises	26
V.	ACCOUNTING FOR ENVIRONMENTAL EFFECTS IN PROGRAM IMPACT EVALUATIONS	31
VI.	CONCLUSIONS	33
	BIBLIOGRAPHY	35

FOREWORD

The Assessing the Impact of Microenterprises (AIMS) Project seeks to gain a better understanding of the processes by which microenterprise programs strengthen businesses and improve the welfare of microentrepreneurs and their households. In addition, it focuses on strengthening the ability of the U. S. Agency for International Development (USAID) and its partners to measure the results of their microenterprise programs. The project's core agenda includes desk studies, focused field research, three major impact assessments, and the development and testing of tools for use by private voluntary organizations and non-governmental organizations to track the impacts of their microenterprise programs. Further information about this USAID-funded project and its publications is available on the AIMS home page (<http://www.mip.org>).

This paper is one in a series of desk studies that addresses specific substantive and methodological issues. The studies are intended to inform the design and implementation of the focused field research, the three core impact assessments and the tools. Each core impact assessment will focus on a specific microenterprise program. Information will be obtained from program participants and a comparable group of non-participants in two main rounds of data collection, with a two year interval between the rounds. Complementary information will be gathered in qualitative interviews and from secondary sources. While this paper furthers the agenda of the AIMS Project, it is also intended to be of interest to others seeking to understand and document the impacts of microenterprise programs.

Carolyn Barnes
AIMS Project Director

EXECUTIVE SUMMARY

This paper analyzes the impact of the program environment -- of factors outside the program itself -- on the generation of socioeconomic benefits through sustainable microlending activities. These programs, their client enterprises, and the households, industries and communities to which the client enterprises are linked are all subject to a host of external influences that help to determine whether, and to what degree, the desired outcomes of microenterprise (ME) support programs are achieved. These outside forces are highly varied and include general features of the physical, cultural, social, and economic setting as well as specific policy and regulatory actions taken by central, regional, and local governments. Collectively, they interact to create the total environment in which ME support programs, their client microenterprises, and their households, industries, and communities all operate. The success of any ME support program depends in part on the influence of environmental factors, which can be substantial in magnitude. In extreme circumstances (e.g. natural disaster or breakdown of civic order), external influences may swamp all the efforts that the actors themselves make.

Environmental influences impact ME programs in two distinct ways. Often, they affect ME programs indirectly through their effects on the client enterprises of the program and their associated households and communities. In other cases, they impact directly on the design and operation of the ME program, often by making sustainability difficult.

The major categories of environmental influence are: (1) the physical environment, including climate; (2) the institutional setting, including informal as well as formal institutions; (3) economic factors; and (4) government policies and regulations. The most important economic factors appear to be: (1) the income and wealth levels of clients and their communities; (2) the rate of inflation; and (3) the structure of markets, both for goods and services produced by microenterprises and for credit.

Government policies and regulations impact microenterprises and ME support programs (either positively or negatively) in many different ways. Either through the formal structure of official policies and regulations or through the manner in which they are implemented, differential effects can emerge on enterprises of different scales, on poor versus nonpoor households, on different industries, and on different regions of the country.

Knowledge about the magnitude of environmental effects on ME programs is still rough, partial, and to some degree disputed. In terms of direct influences on the programs themselves, it is clear that interest rate controls, pressures to raise salaries and other staff benefits, undue limits on deposit taking, and hyperinflation can all have seriously deleterious effects. Other environmental factors (e.g. population density) probably affect the operation and sustainability of these programs as well, but their effects are less well established. Environmental factors that work indirectly through ME client enterprises and related households and communities are highly varied and context-specific. ME program evaluations should be designed with sensitivity to possible differences between program and comparison ("control") groups with respect to population density, mean income level, degree of urbanization, gender, ethnicity, the structure of goods and credit markets, and government policy, regulatory, and enforcement patterns with

special attention to local government actions that might impede microenterprise activities.

I. INTRODUCTION: IMPORTANCE OF THE PROGRAM ENVIRONMENT¹

If successful, sustainable microenterprise (ME) programs can be expected to generate a number of different socioeconomic benefits. These include: higher incomes for the microentrepreneur served and his or her family; increased employment for the entrepreneur's family and other members of their community; broadened participation in business by under-represented groups such as women, rural residents, and subordinated social groups; and improved education, health, and nutrition for members of the affected households and communities. To do this, ME programs supply client microentrepreneurs with credit and/or services and goods such as technical advice, training, equipment, work sites (e.g., markets, shops, factories), and material inputs (e.g., yarn to handloom weavers). Provision of economically and socially beneficial services or goods is either the main objective of the program (if it is operated by a government or non-profit body) or a side-effect of successful commercial operation (if the program is operated by a bank or other profit-seeking financial body). Even if profit is not an objective of the program, the ability to earn at least enough revenue to cover program costs is a sine qua non of program sustainability.

This paper analyses the possible impact of the program environment -- of factors outside the program itself -- on the generation of socioeconomic benefits through sustainable microlending activities. It does not deal with environmental influences on the success of other ME services.

The socioeconomic benefits which ME programs aim to generate materialize, if at all, either through the operations of the microenterprises that the programs try to assist or through other economic activities undertaken by the households and communities in which the assisted enterprises are located. Because credit is fungible, the additional economic activity that is facilitated by the programs may occur outside the confines of the enterprise that is nominally being assisted.

ME programs are operated by several different types of institutions, including government agencies, banks, cooperatives, and other voluntary organizations. Some receive foreign assistance, while others operate entirely on locally generated resources.

The need to cover costs is present whenever the ME program is expected to be sustainable. A sustainable program is one that generates enough revenue to cover all its costs, including the cost of capital from unsubsidized sources such as interbank borrowing and savings accounts, all operating costs (current and capital), and an adequate reserve provision to cover any bad loans that may have to be written off. This requires that loans be made at reasonably high interest rates (sometimes termed "market rates," but the fragmentation of the capital market, described below, makes that specification ambiguous), that defaults on loan repayments be kept

¹ For comments on an earlier version of this paper, the author thanks Carolyn Barnes and Donald Sillers.

fairly low (say 5 percent or less) and that other costs be controlled carefully. Over time, a sustainable microfinance program will be able to build up its capital stock.

Few programs are able to satisfy this definition of sustainability in their early years, but the best ones proceed through a series of steps -- gradually eliminating subsidy elements and covering more cost components -- to satisfaction of this condition.

Sustainability is a condition not only for continuing program operations over time in the absence of continual injections of funds from outside, but also for increasing the geographic, economic, and social reach of the program so that a reasonable fraction of the target population can be served. Sustainability is needed for wide outreach because the coverage of microfinance programs that must depend on outside resources for loanable funds is inevitably limited by the amount of outside funding available. Moreover, the continuation of such programs is inevitably called into question by the likelihood that the donor will some day decide to withdraw its financial support. Sustainable ME programs may make some use of donor funds, particularly in the start-up phase, but they must acquire the ability to finance themselves within the first few years of operation. In addition to cash inflows from loan repayments and interest earnings, a major further boost to the supply of loanable funds becomes possible if they are permitted to accept voluntary deposits from clients. This has the further advantage of providing an additional financial service to the poor, one that is at least as valuable to them as microlending (Robinson 1994). However, not all types of microlending institutions are likely to be able to obtain permission to accept voluntary deposits, since governments usually restrict that right as a way of protecting the public.

Neither the ability of a microlending program to sustain itself nor its ability to attain its socioeconomic objectives is ever dependent solely on the design and operation of the ME program itself. These programs, their client enterprises, and the households, industries and communities to which the client enterprises are linked are all subject to a host of external influences that help to determine whether, and to what degree, the desired outcomes are in fact achieved. For example, an individual ME that is fortunate enough to operate in a relatively prosperous industry or community will find it easier to benefit from ME program services, to survive, grow, and repay its debts than one that must struggle for survival in an economically precarious industry or depressed community. And even if prosperity does not directly benefit the supported enterprise, it may contribute in other ways to the solvency of the household that runs the enterprise, permitting loans to be serviced. Conversely, economic, natural, and civic downturns shrink available funds and heighten competition among their alternative uses, making it hard for individual enterprises and households to repay their loans, let alone to thrive. Disasters in any of these areas can wipe out large numbers of microenterprises, often carrying the ME program with them.

Environmental factors influence the success of all ME support programs through their effects on its client enterprises and on the households, industries and communities with which these enterprises are associated. No matter how great the intelligence, diligence, and imagination of the individual microentrepreneur, his or her business success is subject to the influence of many forces that lie outside the control of the microentrepreneur. These outside forces are highly varied and include general features of the physical, cultural, social, and economic setting as well as specific policy and regulatory actions taken by central, regional, and local governments.

Collectively, all these outside forces interact to create the total environment in which microenterprises, households, industries, and communities operate. Because all these entities are affected by environmental factors, the success of any ME support program also depends in part on their influence. The magnitude of the effect can be substantial. In extreme circumstances, external influences may swamp all the efforts that the actors themselves can make. As the cliché has it, a rising tide lifts all boats; conversely, few prosper in the midst of economic depression, floods, severe droughts, volcanic eruptions, typhoons or civil chaos. As for the potential impact of governmental policies and regulations, the U.S. Supreme Court observed in one of its earliest deliberations that the power to tax is the power to destroy.

Environmental influences impact ME programs in two distinct ways. Often, they affect ME programs indirectly through their effects on the enterprises that the programs seek to serve, as well as their associated households and communities. In other cases, they impact directly on the design and operation of the ME program, often by making sustainability difficult.

Because of the pervasiveness and potential force of environmental influences on ME support programs, it is far from inconceivable that two equally well-designed -- even identical -- programs could achieve sharply differing levels of performance when implemented in different settings. It also seems possible that a well-designed program might fail outright -- or, less plausibly, that a poorly designed one might succeed despite itself -- mainly as a result of environmental influences, rather than because of features in the design and operation of the program itself.

The importance of environmental influences for the success of the individual ME as well as for the welfare of the household and community with which it is associated, and thus for the ME program that tries to assist it, means in turn that environmental influences must also be taken very seriously by evaluators of ME programs. To reach a judgment that a particular ME program meets (or does not meet) some pre-defined performance standard (e.g., of sustainability, or of effectiveness or cost-effectiveness in producing some desired socioeconomic impact), one must take some account of the contributions of outside influences (positive or negative) on the program during the particular time and in the particular place covered by the evaluation. Unless this is done, the general validity of the evaluation -- its applicability to other times and places -- may be limited or even completely vitiated. Similarly, comparative judgments, either about changes over time or about performance differences across cases, must include careful consideration of the possible contributions to observed differences in outcomes made by, respectively, differences in program design and differences in the environments in which the programs were implemented.

The potential influence of variations in environmental forces on observed outcomes requires that the evaluation should be designed to include a comparison or "control" group in addition to the group of program participants being studied. If members of the comparison group are similar to members of the participant sample in inherent characteristics as well as the environment forces to which they are subject, then differences in outcome can plausibly be attributed to program participation. Strictly speaking, the possibility of "selection bias" (systematic differences between participants and others in the population from which they were drawn with respect to characteristics other than participation or non-participation in the program) can be avoided only by randomizing the selection of participants before they enter the program

(although such an experimental approach raises its own difficulties; see Burtless 1995; Heckman and Smith 1995). But a modicum of control can be achieved by selecting a comparison group that is subject to environmental forces similar to those experienced by program participants. Later in the paper we will consider which environmental variables should receive particular attention in designing such a loose control procedure.

This paper seeks to analyze the effects of environmental influences on the success of ME support programs and suggest ways in which they can be taken into account in impact evaluations. While all the major forms of environmental influence are catalogued, attention is concentrated on the effects of government policies and regulations. More specifically, the major purposes of the study are:

1. To identify and analyze the major environmental influences that impact ME programs, MEs, and the households and communities with which they are associated.
2. To suggest which factors impinge differentially on MEs, relative to larger enterprises, or, alternatively, which ones may benefit them differentially.
3. To understand which policies and regulations impinge differentially on poor households, relative to non-poor households.
4. To understand which policies and regulations impinge differentially on MEs by industry and on MEs and households by location.
5. To gain some idea of the magnitude of these effects.
6. To suggest, on this basis, how ME programs may either offset disadvantages related to the policy, regulatory, or economic environment or, failing to do so, be rendered ineffective (or less effective) by them.
7. To understand differences in local policy making and regulation, local enforcement and local economic conditions.
8. To suggest how the core impact assessments of the Assessing the Impacts of Microenterprise Services (AIMS) project should be designed to take account of these policy and regulatory effects. Design issues to be considered include:

The identification of key impact variables (i.e., variables that represent constraints or opportunities arising from the policy, regulatory, or economic environment that are also related to household economic security and/or enterprise stability and growth).

The selection of control variables (to take into account differences in local policies and regulations or their enforcement, and important variations in

local economies).

The identification of factors in the policy, regulatory and economic environment that need to be considered in interpreting study results; that is, the type and size of changes found in key variables (for example, why credit impacts may differ across different types of enterprise according to size and sector, or different types of household according to poverty level).

This study is intended to contribute to the design of the AIMS core impact assessments by (1) identifying the most essential aspects of the national and local level economic, policy, and regulatory environment to be covered in all three core impact assessments and (2) suggesting a standard approach for collecting and interpreting the data.

II. FORMS OF ENVIRONMENTAL INFLUENCE

The purpose of this section is to categorize and discuss the major types of environmental influence that can affect the performance of MEs, the welfare of associated households and communities, and thus the success of ME programs. The major categories identified are as follows:

- C the physical environment
- C the institutional setting (formal and informal)
- C economic factors
- C government policies and regulations

These categories of influence are discussed in order. In each case, we need to distinguish between the extreme situation, in which the environmental influence can swamp the effects of ME programs and of many other forms of human endeavor, and the more normal and common situation, in which environmental influences mix subtly with other factors to determine the outcome of the program.

A. The Physical Environment

How welcoming is the physical environment to human habitation and economic activity? The answer to this question varies greatly across space and time. We can distinguish perennial, seasonal, and exceptional effects.

The effect of climate and other aspects of the physical environment on economic development is a neglected but important topic. Exceptionally hot, cold, dry, or flood-prone regions of the world tend to be lightly populated and poor. Few people live in the polar regions or in deserts; we would not expect microenterprises to succeed, or even be formed, in such harsh settings. Yet a substantial fraction of humanity -- and a far larger share of poor people -- does live in tropical regions, where, as Andrew Kamarck (1976) has pointed out, environmental conditions pose many serious challenges to development that are not encountered in temperate regions. Among the barriers to development analyzed by Kamarck are rainfall and heat, low-quality soils, agricultural enemies (weeds and insects, locusts, trypanosomiasis and others), lack of relevant agricultural research, paucity of mineral deposits, a wide range of health hazards, and a lack of research on how to overcome them. In their broadest application, these factors help to explain why the great majority of tropical nations are poor and why most of the world's poor people live in tropical regions.

Countries with physical environments that pose difficulties for economic development may be heavily populated because international migration is difficult and people have nowhere else to go. Within particular countries, where barriers to movement are far less severe, the most difficult regions tend to be lightly populated. To the extent that the market works, we can expect that the only investments made in those regions will be the few that can hope to earn rates of return comparable to those earned by the majority of businesses that operate in other parts of the country. If microenterprises are in fact formed in sparsely populated regions, however, there may

be a problem serving them cost-effectively through ME programs, since operating costs will be higher and the program may be forced to choose among unpalatable alternatives such as levying extra charges or cross-subsidizing.

In all climates, there is seasonal variation of some form and degree. This is created by more-or-less regular fluctuations in average levels of temperature, precipitation, and/or wind direction. Often seasonal variation is so pronounced that many economic activities (especially forms of agricultural work) can be undertaken only in particular seasons. In such cases, regular seasonal patterns of economic activity typically emerge (e.g., people produce handicrafts or engage in trade during seasons when they cannot farm or fish). To the extent that seasonal variations are regular and predictable, people make adjustments that are also regular and predictable. While microcredit programs may need to be designed to take account of seasonal variation in income flows, this kind of intertemporal problem is one that financial systems can solve through a combination of credit and savings services. People can also contribute to their solution by developing diversified sources of income that can be drawn upon for loan repayment. Predictable fluctuations in income over time are in fact relatively easy to deal with.

While adjustments to regional and seasonal variations in environmental influences are thus not too difficult to make, exceptional events such as severe storms, floods, droughts, and volcanic eruptions are much harder to anticipate and prepare for. Even if the typical location and average frequency of their occurrence are known, the onslaught of particular events may be highly unpredictable. Often people are simply too poor to insure themselves against natural disasters, either by purchasing insurance policies or by taking other steps to reduce their prospective costs of a disaster for their businesses, families, and communities. In the worst case, such as the delta of Bangladesh and eruption-prone regions of the Philippines, significant numbers of people have no better alternative than to struggle for survival in a region where disaster is virtually certain to strike at some time over a period of several years. In such cases, catastrophe becomes almost predictable and must be built into the ME program, perhaps by requiring that participants reserve some funds for use in disasters and ensuring that the program does the same. This, however, is costly and may not be compatible with sustainability.

B. Formal and Informal Institutions

In all societies, many rules of different kinds govern economic and social transactions. According to writers such as Oliver Williamson (1985) and Douglass C. North (1990, 1994), the gradual development of these rules and their enforcement mechanisms is fundamental to the achievement of economic development.

A institutions form the incentive structure of a society, and...in consequence are the underlying determinants of economic performance...Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies. It is adaptive rather than allocative efficiency which is the key to long-run growth. Successful

political/economic systems have evolved flexible institutional structures that can survive the shocks and changes that are a part of successful evolution. But these systems have been a product of long gestation. We do not know how to create adaptive efficiency in the short run.@ (North 1994, 359-360, 367).

While all societies possess institutions of some kind, their institutional structures may be either more or less conducive to economic development. The growth of formal rules and the institutions needed to enforce them systematically (e.g. courts) tends to be associated with economic development, but, as North points out,

While formal rules may be changed overnight, the informal norms usually change only gradually. Since it is the norms that provide legitimacy to a set of rules, revolutionary change is never as revolutionary as its supporters desire, and performance will be different than anticipated. And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement. The implication is that transferring the formal political and economic rules of successful Western market economies to third-world and Eastern European economies is not a sufficient condition for good economic performance.@ (North 1994, 367).

Since investment in a ME, or any other business, typically requires that up-front expenditures be made in anticipation of future revenues, the level and predictability of the anticipated future returns become critical issues. The level of investment is strongly affected by the presence or absence of institutions and enforcement mechanisms that (1) raise the expected rate of return and (2) reduce the range of uncertainty attached to any expected rate of return, even a low one. These outcomes can be promoted by passing laws favorable to business investment and consistently enforcing them through a formal system of tax collectors, commercial courts, etc. In developing countries, however, these institutions and enforcement mechanisms may either be underdeveloped or, where they exist, may not work as they do in high income countries. This can reduce the expected return on business investment and increase its riskiness. In some cases, social norms and enforcement mechanisms substitute reasonably effectively for the missing formal ones, but informal systems are likely to work best within relatively small and cohesive sub-groups, as discussed below. For the remainder of the population, business investment in a low income country is likely to involve a lower expected profit and higher risk than would exist if formal mechanisms governing contract enforcement and other business practices were better developed.

A related issue is the ability of the government to invest in, and operate, various forms of infrastructure, physical facilities (and, by analogy, social facilities such as schools and health clinics) that help to raise the rate of return on private investment.

Weak institutions and formal enforcement mechanisms are common features of developing countries. Gunnar Myrdal (1968) coined the term soft state@ to refer to governments that pass many laws and make frequent policy pronouncements but possess little capacity to enforce their writ in society. Often, in these conditions, enforcement is highly selective and fails to reach certain regions of the country and levels of interaction.

Related to the weakness and selectivity of enforcement, as well as to poverty and other factors, is the prevalence of corruption. Where laws are only enforced sporadically, and especially when valuable privileges are distributed, and costly penalties imposed, through case-by-case administrative actions, incentives are created for enforcement agents to levy charges on the public as a condition either of receiving some favor (e.g., a license) that it is within their power to bestow or of avoiding some penalty (e.g., a tax payment or fine) that the official can impose on those who refuse to pay the bribe solicited. The effect of corruption on economic development has been widely debated. From the business person's point of view, payments to corrupt officials are an additional cost of doing business and thus worsen the business environment, compared to a situation in which such payments do not have to be made. Moreover, the timing and amount of such exactions may be unpredictable and thus disruptive of business operations. Still, bribes are likely to represent a smaller addition to the cost of doing business than the official taxes whose payment the bribes permit business people to avoid and the laws and regulations they allow them to circumvent. Given the existence of high taxes and restrictive laws and regulations, therefore, some have argued that corrupt payments may facilitate business activity that otherwise would not take place, and in this sense promote efficiency. This, however, does not deny that a more formal and transparent system with reasonable tax rates, laws and regulations would be more efficient yet.

Even an honest and efficiently-run judicial system may involve costs that make it difficult for microenterprises to use it as a means of contract enforcement. For this to happen, special arrangements such as small claims courts may be required.

The most extreme manifestation of the weakness of governments, institutions and formal enforcement mechanisms in developing countries is the sort of breakdown in civil order that has occurred from time to time in all too many developing countries. Periods of lawlessness caused by civil wars and local rebellions severely disrupt business enterprise and threaten human safety. They also make it virtually impossible to operate ME programs (as, for example, in Liberia recently). It has been alleged, although controversially, that such breakdowns are becoming more common in Sub-Saharan Africa and that this trend poses a threat of general economic decline, reaching even to regions outside Africa (Kaplan 1994).

All societies, however, have informal institutions with important implications for microenterprises and ME programs. All societies are divided by gender and at least half the nations of the world also feature sharp splits along class, racial, ethnic, religious, linguistic, or caste lines -- often in some combination. Opportunities available to individuals frequently differ according to their membership in one or more of these groups. General social subordination -- of women, lower castes, or ethnic minorities -- is likely to harm the business prospects of members of the subordinated categories. They may well be denied licenses, credit, and other business advantages. This may exclude them from business altogether, or it may force them to operate informally or on a small scale. It may also limit the range of their customers and business associates to other members of their own group, who may be relatively few in number and have low average incomes.

While such discrimination is likely to discourage participation in business by disfavored groups, discrimination in other areas of society may actually promote their business activities. For example, limitations on access to government jobs or higher education may force the victims of such discrimination to participate disproportionately in business. It has long been recognized that many of the leading entrepreneurs in the British industrial revolution were members of dissenting religious minorities who were banned from public office and certain other spheres of public life. Entrepreneurial minorities exist in many societies. Often discrimination against them by the majority serves to strengthen the internal cohesion and solidarity of a minority. This in turn can benefit their business activities. Business people from the minority group cooperate in many ways -- in buying, selling, borrowing and lending, hiring, etc. -- to their mutual benefit. Business ties are strengthened and informal contracts enforced by virtue of the linkage between specific business transactions and one's acceptance as a member in good standing of the social group, a status which is particularly likely to be prized when the broader society is perceived as alien and even threatening. Thus, Apost-contract opportunism (cheating on business agreements) is much less likely to occur among fellow members of a cohesive minority than in situations where transactors have fewer linkages with each other and may not even expect ever to meet again (Williamson 1985). This can give business people from the entrepreneurial minority community a substantial competitive advantage, compared to members of the majority. Such an informal advantage can be especially telling in countries where formal institutions and enforcement mechanisms are weak.

C. Economic Factors

Many dimensions of economic differentiation could be identified, but some of the most important are probably different degrees of wealth or poverty, as well as rates of change of these states in the long or short run. In other words, the poverty or prosperity of the nation, community or household in which the ME program is implemented is likely to be significant, as are the national and regional long-term rates of economic growth (sign and magnitude) and any short-term economic fluctuations that may occur during the period of study. Other important factors are inflation and the structure of markets, both for goods and services and for credit.

1. Income and Wealth

It is clear that ample or growing wealth makes it easier to repay loans. Given fungibility, a borrower's ability to service a loan depends much less on the quality of the project for which the loan proceeds were intended to be used than on his or her overall wealth and liquidity. A borrower who is moderately wealthy, or at least liquid, and whose income is rising, has a substantial ability to repay, even if the project for which he or she borrowed from the microcredit program is a total failure. By contrast, poor borrowers may find it very difficult to repay -- even when their projects succeed -- because they are less liquid and have fewer and smaller income flows and asset stocks to draw upon.

Loan repayment rates do not, however, depend solely on the ability to repay. The incentive to repay is also important, and may work to offset the richer or more liquid borrower's greater ability to repay. For the richer borrower, the incentive to repay may be weaker because

the well-off typically have other sources of credit that they can draw upon in case of need. The poorer borrower, by contrast, has few available sources of credit, and is thus strongly motivated to repay outstanding loans if the availability of credit in the future appears to depend on it. This tendency for ability to repay and incentive to repay to work in opposite directions in relation to income or wealth creates ambiguity about the comparative repayment rates of poor and non-poor borrowers. In many cases, poor borrowers have demonstrated higher repayment rates, despite the greater vulnerability of poor borrowers to environmental shocks.

While the relationship between the wealth and income levels of borrowers and their repayment rates may be uncertain, there is little doubt that average repayment rates are likely to be higher in growing economies than in stagnant ones, and higher also in boom periods than in recessions. Again, fungibility is the key to understanding these relationships because it is not only the profitability of the project being financed that determines the repayment rate (although that too will vary with the growth rate and the business cycle), but also the availability of other assets or cash flows that can be drawn upon to make payments.

2. Inflation

Another economic factor likely to be significant for ME credit programs is the degree of monetary and price stability. Inflation redistributes income and in many cases retards economic growth. It also complicates financial contract-making, particularly when the rate of inflation changes sharply and unexpectedly. A lender may make a loan at what appears to be a high enough interest rate to cover its costs and ensure the sustainability of the credit program, then discover that inflation has picked up, turning the interest rate negative in real terms (making it less than the rate of inflation) and causing the real value of the lender's capital fund to run down over time. A negative real rate of return will discourage future lending, particularly if it persists for a considerable period and there are impediments (for example, government regulations or political considerations) to restoring a real interest rate that is not only positive but high enough to cover program costs. The worst case is one in which the government, not the market, sets the interest rate, and uses this power to establish a nominal rate so low that the real rate of interest is negative. This will cause the supply of legal credit to dry up; any future loans will be made illegally at interest rates above the government's prescribed ceiling. This type of financial repression is particularly harmful to ME lending (as opposed to other types of loans), since small loans carry higher risks and transaction costs, and thus must be made at higher interest rates. They are thus likely to be the first type of loan to be affected by any legal ceiling on interest rates.

3. Market Structure

A final significant aspect of the ME support program's economic environment is the structure of markets, including both markets for the goods and services produced by microenterprises and the credit markets in which they borrow. In the markets for ME goods and services, the crucial issue is the price elasticity of demand. In other words, if ME credit and other services enable client enterprises to increase production, how much effect will the increased supply have on the prices at which the goods and services can be sold? Any particular ME that

sells its produce or service in a competitive market should be small enough in relation to the market served that increases in its sales will have no noticeable effect on price. If, however, the ME program makes loans to many producers in the same sector, then the increase in supply could become large enough to affect the price. The next question is how large the effect is likely to be.

The general rule here is that the wider the market served, the higher the price elasticity of demand and the more production can rise without substantially depressing the price. In narrow local markets, relatively small increases in production can cause prices to collapse. This occurs when, for one reason or another -- e.g., high transportation costs, restrictions on interregional trade, or local differences in taste -- it is hard to sell the ME output outside the local market. The other extreme is encountered in the case of products that are exported: in that case, the demand curve faced by the industry is in effect perfectly elastic. All enterprises can expand their production, almost indefinitely, without depressing the price. It is very hard, however, for microenterprises to export. Usually, strong private sector support mechanisms are required to help them deal with the marketing, standardization, production scheduling and other problems involved.

Microenterprises that encounter sharp declines in product prices when they attempt to expand production are likely to change their business plans. If the loan proceeds are still used in the activity for which the loan was taken, they are likely to be devoted to cost reduction (e.g., by substituting capital for labor), rather than expansion of production. Another strong possibility is that the loan proceeds will be diverted to another economic activity.

Competition also occurs in the market for credit. Typically, a sustainable ME program lends at rates that are higher than those charged by subsidized credit programs (and also above the prime rate that banks charge their best large customers), yet lower than the rates charged by moneylenders, traders and other informal lenders (excluding family members and friends, who may be willing to lend at zero or low interest but usually have only limited sums to make available). The rate is attractive both to the lender, who has an opportunity to cover the higher transaction costs (and possibly risk) associated with ME lending, and to the borrower, who can save substantial amounts over the interest that moneylenders and those engaged in linked transactions would charge (although the latter might disguise the true interest rate by including part of the interest payment in other prices).

Expansion of a sustainable microfinance program should have increasingly evident effects on the credit market over time. At first, the activities of other lenders may not be noticeably affected, but if the program continues to grow and becomes a large enough part of the total market for credit, they will eventually have to adjust. Two forms of adjustment are to be expected. The first is that moneylenders and other informal lenders will either withdraw from this market or soften their terms in an attempt to compete better against the ME program. The second form of adjustment is that other commercial banks or other formal lenders may decide to enter this market, having been shown that it can be profitable. Both forms of adjustment lead to increasing competition for the ME lender and better access to credit on easier terms for borrowers.

In closing, it should be emphasized that market effects are a concern only after market shares become "large" (but there is no precise measure of how large they have to be). As long as the lending program remains a small part of the overall credit market and its client enterprises remain small proportions of their respective industries, no significant market effects should be expected.

D. Government Policies and Regulations

Government policies and regulations impact microenterprises and ME support programs in many different ways. Some of their impacts are positive, but many are negative. Here we distinguish between official programs to promote micro and small enterprises and policies and regulations promulgated by national and subnational governments that impact microenterprises and ME support programs. The policies and regulations, in turn, can affect ME programs either indirectly through their effects on program clients or directly by limiting what the program can do.

Over the years, nearly all governments in developing countries have issued policy statements that pledge support for micro and small enterprises (MSEs). In addition, almost as many have undertaken promotional programs intended to achieve this objective. Many of these programs seek to target several kinds of assistance to MSEs: credit, technical assistance, training, and facilities such as market sites and small industrial estates. In general, the record of these programs is undistinguished (Snodgrass and Biggs 1996, Chapter 4). As a result, the old-style government assistance programs have been replaced, or at least supplemented, in many developing countries, by two newer types of program: (1) officially-sponsored **A minimalist@** programs that limit themselves to the provision of credit, increasingly on **A market terms,@** and (2) private-sector endeavors of many different types, including traditional programs run by non-governmental organizations (NGOs), interventions by business groups, and profit-seeking microfinance programs run by private banks.

In sharp contrast to the unfailingly positive policy pronouncements and the well-meant but often ineffectual official programs intended to assist MSEs, the impact of government policies and regulation on microenterprises and ME support programs is far from consistently positive. A wide range of government policies and regulations, almost invariably enacted with other objectives in mind, impact on small and microenterprises (Haggblade, Liedholm and Mead 1990). Many of these policies and regulations have effects on MSEs that differ from their impacts on larger businesses. Frequently, although not always, the differential impact on micro and small enterprises, compared to larger firms, is negative. As a result, the ability of MSEs to compete successfully with larger firms is reduced. Since official programs intended to promote MSEs are typically quite limited in scale and many appear to be ineffective, it seems safe to say that, on balance, the actions of most developing country governments belie their words. While their policy statements imply that they favor MSEs, the policies and regulations that they actually enact tend to tip the playing field on which enterprises of different scales compete in favor of the larger firms (Snodgrass and Biggs 1996).

1. Indirect Impacts through Effects on Microenterprises

Many different government policies and regulations influence the performance of MSEs in developing countries, with effects that are complex and difficult to sort out. One can, however, get a sense of the manner and scope of their impact by starting with the observation that most policies and regulations achieve their influence by working through two kinds of markets: those in which MSEs sell their products and those in which they buy factors of production and inputs.

Table 1, developed by Haggblade, Liedholm and Mead (1990), provides an inventory of policies and regulations that have significant effects on MSEs. In this table, policies are arranged according to standard functional categories. Table 2, also from Haggblade, Liedholm and Mead, reformats the same information to show which policies and regulations work through which markets. It suggests which policies have at least a first-round impact on the price of capital, the price of labor, prices of material inputs, and the profitability of various lines and techniques of production and the structure of demand for MSE products.

Some of the most important policies that work through factor markets are exchange rates, tariffs, and interest rates. All these policies affect the prices enterprises must pay for capital; often, the magnitude of the effect varies by the scale of enterprise. Similarly, minimum wage laws, other types of protective labor legislation, government salary structures, and policies governing labor union activities all influence the price of labor. Tariff rates, exchange rates, foreign exchange controls, and domestic price controls all affect the prices of purchased inputs. Zoning regulations and licensing laws also affect the relative profitability of different enterprise size groups.

In output markets, all kinds of trade policies affect the demand for many domestic products through either the price of competing imports or the price at which exports can be sold. An even wider array of trade, fiscal, and price policies influences the sectoral and size distribution of income.

Most of these policies work through prices. Others, such as quotas, licensing and zoning, work through access. Such entitlements are supposed to be allocated on non-market criteria; prices enter in only if some enterprising official decides to sell the rights at his or her disposal.

Any policy that causes the prices that MSEs have to pay for their inputs to be higher than those that larger enterprises pay for the same inputs reduces the competitiveness of the MSEs. A policy that causes the prices that MSEs realize for their outputs to be lower than those obtained by other firms selling the same product has a similar effect. Such differential effects harmful to MSEs can be termed policy bias. Often the bias is unintended. For example, the system of combining exchange controls with an overvalued exchange rate, which was once common among developing countries and persists today in some countries, is intended to promote the production of import substitutes, not to make capital goods more expensive for MSEs than for larger firms. Nevertheless, if machinery and transportation equipment must be imported and MSEs find it difficult or impossible to obtain foreign exchange licenses and thus have to purchase foreign exchange at higher rates on the curb markets, that is its effect.

In a perfectly competitive market, there is a single price for each good and service traded, but if markets are segmented different prices can prevail in various segments of the market. This leads to allocative inefficiency and hence to lower output than would prevail in a distortion-free world. Biases in the trade, credit, and fiscal policies of many developing countries are widely believed to induce substitution of capital for labor in the larger, more formal firms, which can often obtain capital at an artificially low price and may have to pay an artificially high price for labor.

Many observed price differentials, however, are not price distortions, but instead reflect differences in either the quality of the goods and services traded or the costs of serving different customers. In practice, it may be hard to distinguish between the two phenomena. For example, a small enterprise located outside the capital city might have to pay a higher interest rate than a large one located in the capital. That could be a price distortion, but it could also be a reflection of the bank's need to bear higher transaction costs and risk for the former borrower than for the latter.

For purposes of comparison across programs, and thus probably across regions of the country, it becomes important to know which policies and regulations are imposed by which level of government: national, regional or local. Policies and regulations that derive from the national government are often assumed to apply uniformly in all regions and in rural as well as urban areas. This assumption is unlikely to be valid. Usually there is some regional variation in enforcement, especially within large countries. Policies and regulations imposed by regional and local governments are obviously applicable only to the areas within the respective jurisdictions of these governments.

Most of the policies listed in Tables 1 and 2 are enacted by national governments in most countries. Some, however, are within the purview of regional and local administrations. In most developing countries, even many of those that are formally classified as federal rather than unitary, all the major tax and regulatory powers are assumed by the national government, while those that

are left to sub-national governments are frequently regarded as comparatively minor. Yet it is precisely these "minor" taxes and regulations that may be most significant for microenterprises. Examples would be business and site licensing, sanitary regulations, environmental zoning, traffic control, labor practices, relations with the providers of public utilities, and minor local taxes on business. Such provisions are not usually regarded as matters of high policy and they usually do not have a significant effect on total tax collections, but they can loom large in relation to the low-level business operations of MSEs and they may be significant sources of finance for local jurisdictions.

Looked at from a national point of view, the entire framework of governmental policy and business regulation can be seen as either relatively friendly or unfriendly to business in general. At one limit, the policy framework may be so negative and restrictive as to render the conduct of business very difficult and drive many of the surviving business operations underground. Even in such forbidding circumstances, however, people find ways to conduct business and ensure their families' survival.

In most countries, however, and specifically in the context of impact evaluation, the most important issue is less likely to be the overall impact of government policies and regulations on business than their differential impacts across businesses that differ by scale of operation, industry and region of the country. That topic is addressed in Section III of this paper.

In addition to the question of what policies and regulations have been enacted by the government, there is the equally important issue of the manner in which these policies and regulations are -- or are not -- implemented. Again, there are questions of overall and differential impact. The harsher the policies, the more difficult they are to enforce effectively, and the more likely various forms of evasion therefore become. In such settings, the operation of a ME service program can be very difficult. More generally, the consistency with which taxes and regulations are enforced throughout a society seems to vary widely among countries, reflecting the kinds of differences in the political and institutional environment that were discussed earlier. For example, Brian Levy (1991) surveyed the business constraints reported by microentrepreneurs in Sri Lanka and Tanzania. He found that while formal tax and regulatory requirements were demanding in both countries, in Sri Lanka opportunities to evade taxes and business regulations were substantially greater for smaller firms than for larger ones, and greater also for informal undertakings than for legally registered enterprises. In Tanzania, while the formal impositions were no stricter than in Sri Lanka, they were **A**comprehensively enforced, albeit with pervasive lubrication and renegotiation of formal obligations[@] (Levy 1991, 26). In Sri Lanka, lax enforcement on small, informal enterprises encouraged MSEs to remain small and avoid crossing the threshold above which they would become subject to higher taxation and tighter regulation. By contrast, **A**the effect of the Tanzanian pattern is to impose entry and expansion-detering costs on all enterprises, both financial costs and the opportunity cost associated with the diversion of scarce entrepreneurial time and effort away from socially efficient wealth-creating activities[@] (Levy 1991, 26). Given the sharp differences in consistency of enforcement that Levy found in these two countries, the whole issue of whether governments in developing countries enforce their policies and regulations consistently across enterprise scale groups must be regarded as open and subject to investigation on a country-by-country basis.

Sporadic enforcement of taxes and regulations -- a pattern that involves neither consistent enforcement nor consistent neglect -- is probably common among microenterprises in developing countries. As compared to total and consistent enforcement of a given level of taxes and restrictions on business, this approach places lower costs on microenterprises and thus increases their expected average profits. At the same time, however, it increases the level of uncertainty that they face, since a sudden "raid" -- prompted either by legal motives such as a sudden resolve to increase tax revenues or enforce long-neglected regulations or by corrupt motives (the desire of enforcers to wring larger illegal exactions from business) -- can impose heavy, unforeseen costs on the microenterprise. Many microentrepreneurs have lamented the disruptive effects of such raids on their businesses.

2. Direct Impacts on ME Programs

The preceding discussion emphasized ways in which government policies and regulations can affect the performance of ME service programs through their impact on program clients. Governments may also enact policies and regulations that directly affect the operations of these programs. This is most evident in the area of financial services. The effect of interest rate ceilings on microlending operations has already been discussed. Besides making it unprofitable to lend to MSEs, these regulations have another deleterious effect on microfinance institutions. That is to make it harder for them to attract the deposits that provide, potentially, the most important source of funds for microlending. If the interest rate at which loans are made is held down, then it becomes more difficult to attract deposits with the necessary positive interest rate spread. Although savers may be relatively insensitive to the interest rate earned on their deposits, placing greater emphasis on the safety and convenience of their accounts, it is usually necessary to offer some positive real interest rate to attract deposits.

A related issue concerns what types of financial institutions are permitted to accept deposits. For good reasons, all governments enact rules that define what types of institutions that may go into the deposit-taking business, often limiting the privilege to those that meet the demanding criteria to qualify to be called banks. While there is an obvious need to protect the public from those who might wish to steal their savings, a countervailing objective is to promote the growth of financial institutions, including banks and other bodies that lend to MSEs. Prohibiting such lenders from accepting voluntary deposits will stifle their growth in the long run. In some countries, banks and other institutions that are forbidden to accept voluntary deposits are permitted to require borrowers to hold a certain fraction of the proceeds of any loan received on deposit in the lending institution. While borrowers may accept such a requirement as an additional cost of obtaining needed credit, these forced savings are no substitute for voluntary savings accounts that assist people to manage their assets.

E. **Conclusion**

As this review has made clear, a wide range of environmental factors -- having to do with the physical environment, the presence or absence of civic order, social factors, economic factors, and policies and regulations enacted by national, regional, and local governments as well as the manner of their enforcement -- can significantly influence the business success and welfare of the

clients of ME service programs as well as the prosperity of the households and communities from which the clients come. It follows that what an evaluator might take as the success of a ME program (on socioeconomic or financial criteria) could in fact be attributable in large part to a relatively favorable program environment. By the same token, the evident failure of another such program may be less a matter of poor program design or management than of the presence of a program environment so adverse that it would have been hard for any form of assistance to microenterprises to achieve its objectives in that setting.

III. DIFFERENTIAL EFFECTS OF POLICIES AND REGULATIONS

A. By Scale of Enterprise

The size distribution of nonagricultural enterprises in low- and middle-income countries is typically dominated by micro, small, and medium-sized enterprises. It is common for these smaller firms to make up over 90 percent of the business enterprises in the country, to employ three-quarters or more of the labor force, and to make a substantial (although smaller) contribution to GDP. As countries develop, the importance of these smaller firms gradually declines, but they remain important in all high-income countries and play a particularly prominent role in a few rich countries such as Japan and Italy (Snodgrass and Biggs 1996). Given the importance of MSEs as a source of livelihood in developing countries, it is remarkable that many of the policies that prevail in most of these countries disadvantage smaller enterprises and favor the much smaller number of larger firms that exist in those countries. This section reviews what is known about this form of policy bias, as well as about the smaller number of cases in which policy actually favors the development of MSEs. The discussion is organized in terms of the markets through which various policies work (see Table 2). We look first at factor markets, then at product markets.

Labor markets in developing countries are often described as segmented. Large and small enterprises may hire labor in different market segments. There is a gap between wages paid by large and small employers. This gap is wide in developing countries and smaller but still present in developed countries. While there is much dispersion in the wages paid by small firms in developing countries, on average they pay only about half as much for unskilled labor as large firms pay. While part of this gap represents the desire of large firms to minimize labor turnover by selecting the most proficient and reliable workers, another part is often attributable to policy interventions which have differing effects on enterprises of different sizes. These include minimum wage legislation, mandated fringe benefits, restrictions on the employer's right to fire workers, and government-supported union pressures. While such interventions are common in developing countries (but have never been practiced, it is interesting to observe, in the high-performing East Asian economies), they usually apply only to the larger, more visible enterprises. Smaller firms are usually either exempt from these laws or escape their application through lax enforcement. This may permit them to hire comparable labor at lower wages than large enterprises must pay, gaining a competitive advantage. The extent of this advantage, however, has probably diminished in the past 10-20 years. Richard Freeman (1993) concludes that while labor market interventions may have created significant distortions in the 1960s and 1970s, their effect declined sharply in the 1980s.

Domestic capital markets, like labor markets, are often said to be segmented. Large firms with established credit ratings can usually borrow from banks and other formal sector financial institutions while MSEs must rely almost entirely on traditional sources of funds, particularly personal and family savings. When small and microentrepreneurs do go outside their immediate circles for credit, they usually turn to informal-sector sources such as traders, suppliers of goods and moneylenders. Surveys of microenterprises conducted in several developing countries suggest that less than one percent of small producers' initial investment funds came from formal

borrowing (Liedholm and Mead 1986).

Capital costs in formal and traditional markets diverge sharply. Interest rate ceilings commonly applied to formal sector lending in developing countries, at least until financial sector reforms gathered momentum in the 1980s. These ceilings created a situation in which there was excess demand for loans at existing, artificially low, interest rates. Banks responded by rationing their scarce funds and giving priority to larger-scale customers. A wealth of evidence shows that interest rates in informal credit markets were much higher, often 100 percent a year or more in nominal terms. The higher risks and transaction costs associated with small-scale lending explain only a part of this huge differential. In a well-designed microcredit program, administrative cost can be less than 6 percent of loan value (Saito and Villanueva 1981; Liedholm 1985; Snodgrass and Patten 1991). Moreover, the high arrears and default rates of most small-loan programs contrast sharply with the experiences of a few well-designed programs (Hossain 1988; Patten and Rosengard 1991; Christen, Rhyne and Vogel 1994).

The tariff structure and the operations of the foreign exchange market can also introduce distortions that differentially affect labor and capital use in large and small enterprises. The import duty structure has two important effects. First, many capital and intermediate goods used by small firms, especially microenterprises, are classified as consumer goods. Examples include sewing machines, hand tools and outboard motors. Since in most countries consumer goods attract far higher duties than intermediate and capital goods, MSEs must pay relatively high duties on their equipment. Second, firms approved for official investment incentives are often exempted from duties on imported capital equipment for extended periods. In some countries, firms below a certain size are legally excluded from these provisions. More commonly, MSEs could apply but are either unaware of what concessions are available or unable to comply with the complex bureaucratic procedures required to obtain them.

Currency overvaluation further widens the differentials in capital prices faced by large and small enterprises. Overvaluation creates excess demand for foreign exchange and thus requires that it be rationed. This creates price discrimination in the market for imported capital and intermediate goods, since those who can obtain access to rationed foreign exchange pay lower prices than those who cannot obtain such access. Although there has been a trend toward freer exchange rates over the past two decades, currency overvaluation has affected a wide range of countries and remains significant in many today.

Domestic tax policies can also have differential effects on large and small enterprises. Official investment promotion policies often provide large firms not just with subsidized capital and import duty relief but also with other incentives such as income tax holidays, accelerated depreciation allowances and property tax reductions. These direct tax concessions raise returns to capital in those large firms that receive them. On the other hand, small unincorporated enterprises are often legally exempt from direct taxes, and thus gain a competitive advantage over larger rivals. In other instances, MSEs legally subject to tax escape payment because of slack enforcement and the difficulty of collecting taxes from numerous widely dispersed firms. In environments where tax evasion is common, however, large firms may also be able to avoid tax payments.

In summary, capital market distortions arising from domestic or foreign trade policies appear significant in nearly every developing country. Differences in capital costs between large and small firms varied from 30 to 65 percent among countries studied in the late 1960s and early 1970s (Snodgrass and Biggs 1996, 93). These differences are greatest in countries that are following import-substitution strategies, where both domestic and foreign trade policies contribute to the capital price distortion. Yet distortions also exist in export-promotion countries, primarily as a result of domestic policies.

Product markets are distorted by many forces, but most noticeably by foreign trade policies. In several countries, protection from import competition has been found to favor industries dominated by large firms. Similarly, incentives to export are sometimes offered only to larger firms. This was the case in South Korea, where exports have been dominated by large firms (Frank, Kim and Westphal 1978). In Taiwan, on the other hand, export promotion policy was less discriminatory and small firms have played a much larger role in industrialization and export growth.

Another form of product market distortion is discrimination against agriculture in trade and other policies. While many branches of manufacturing enjoy high rates of effective protection, agricultural products often receive negligible or even negative effective protection (in the latter case, they are adversely affected because the inputs that they buy are more heavily protected than the products that they sell). Heavy taxation of agriculture hits small-scale nonagricultural enterprises as well, particularly those located in rural areas and small towns. Studies in a number of countries have indicated that the growth of these firms is closely linked to the growth of agriculture, both on the demand side (farmers buy many of their products and services) and on the supply side (the nonagricultural small enterprises depend on agriculture for many of their inputs) (see, for example, Ranis and Stewart 1987).

B. By Household Income Level

Since micro and small enterprises are normally owned and operated by relatively poor people, policy and regulatory biases against such enterprises are usually also anti-poor. In general, the smaller the enterprise, the poorer the owner is likely to be. Not everyone, however, can start an enterprise, even a very small one. In low-income countries, there are often groups of people who have to struggle daily to survive, working as daily laborers at some of the least desirable jobs that society has to offer. They own hardly any property and are likely to have had very little schooling (years of schooling correlate positively with the earnings levels of the self-employed). These poorest of the poor, who are present in large numbers only in very poor countries but are quite numerous there, are unlikely to be able to set themselves up in business, even as owners of microenterprises. In these settings, microentrepreneurs might in fact be expected to come from the upper half of the local (rural or small-town) income distribution, although they might still qualify as poor within the national income distribution.

There is, of course, a massive literature to show that government policies and regulations are frequently biased against the poor in developing countries. The "urban bias" demonstrated in

great detail by Michael Lipton (1977) is just one aspect of this. In most countries, the provision of infrastructure and social services such as education and health are biased against the poor. Sometimes this bias is pronounced, sometimes more subtle. Not only are the levels of public subsidization often higher for services consumed primarily by the better-off (e.g., public universities vs. primary schools), but basic services intended for the poor (e.g. rural primary schools and primary health clinics) are often either absent or do not function as they should. Frequently, the poor have difficulty making even the nominal private financial contributions required for participation in public programs (e.g., book and uniform fees in primary schools) and as a consequence are forced to drop out of these programs.

As a clear example of the effects of anti-poor regulatory bias, one can consider the policy adopted by the Jakarta Municipality in the late 1970s and early 1980s to regulate the becak (pedal rickshaw) industry. In the early 1970s, over one million poor people were employed in this industry as microentrepreneurs and employees of small-scale transportation enterprises. Some 3-4 million individuals were supported by their earnings. Besides serving as major sources of urban income and employment, becaks also benefited poor people as consumers, since they provided a cheap source of middle-distance transportation for both passengers and goods within a very large city. Yet the municipal government, eager to open up thoroughfares to motorized transportation, and wishing to present itself as "modern" to visitors to the national capital, progressively restricted their operation and eventually banned them entirely within the municipal boundaries. While this policy probably provided some marginal reduction in the traffic congestion faced by those Jakartans who could afford to travel by bus, taxi or private car, it imposed large costs on the poor. Lenders who had been financing becak purchases could have suffered loan defaults, although the policy shift took long enough coming that it probably was fully anticipated.

The many disabilities suffered by the poor make it difficult for them to participate in ME programs because their poverty greatly complicates both the operation of a functioning microenterprise and the repayment of money borrowed from such programs. Yet, as noted earlier, a few microfinance programs have attained high repayment rates from low-income borrowers. Their success may be attributable partly to program design features that help them work effectively with the very poor and partly to the aforementioned need of poor borrowers to keep open what may be their sole credit source.

C. By Industry

Most government policies and regulations are not aimed at specific industries and do not have any clear-cut cross-industry bias. Occasionally, however, governments will single out particular industries for either favorable or unfavorable attention. For example, industries thought to provide substantial linkages with other industries and to serve as markers of modernity and prestige may be given special favor by government policies. Such industries usually feature strong economies of scale, and these "industrial policy" considerations are one of the major sources of large-firm bias discussed at length above. Occasionally an industry dominated by small and microenterprises will be singled out for special favor for ideological or other reasons, as in the case of handloom weaving in India. If protection of such small-scale activities becomes great enough, large firms may begin to enter the industry, disguised as small enterprises.

Seldom is an industry banned or generally restricted, except on religious or moral grounds (e.g., cattle slaughtering in India; pork and alcoholic beverages in some Muslim countries). More commonly, bans and prohibitions are limited to specific areas of the country. For example, abattoirs and tanneries may be forbidden close to residential areas. These are often legitimate forms of regulation in the public interest and should not be regarded as bias against specific industries.

D. By Region

The regional spread of economic development is always uneven, and this often becomes a source of discontent, particularly when specific regions of the country are identified with major ethnic, linguistic or religious groups. While a certain amount of regional inequality is a normal by-product of development and tends to be self-correcting over time, governments often exaggerate this inequality through their policies and expenditure patterns. In Thailand, for example, Bangkok and its surrounding region dominate national life for a combination of economic and political reasons. Rapidly rising congestion and associated increases in production costs are beginning to push economic activity out toward regional centers, but to accelerate the process the government would have to make decisions to decentralize some of its own activities that it may be loathe to make.

In the early stages of economic development, while the national market is still poorly integrated, local producers may enjoy a degree of "natural protection" from outside competition as a result of high transportation and communication costs. As these costs fall, markets widen and firms that can realize economies of scale are able to increase their market shares. This is one of the major reasons why larger enterprises tend to displace smaller ones as countries grow richer. This process may have strong regional implications, as production of some items moves away from the consumers and into the lowest-cost production areas.

Producers in central areas normally have advantages over producers in more remote regions that arise from lower transportation costs, better access to markets, higher-quality infrastructure and social services, and superior business information. While these advantages are important to large firms, they may be even more important to efficient small enterprises, since they are able to incorporate less of what is needed for efficient and profitable operations within themselves than are the larger firms. Small firms have to rely more on the market and frequently depend on their relationships with other small enterprises with which they have repeated transactions. This can produce clusters of small enterprises that may be highly concentrated in regional terms. Contrary to the traditional argument that one reason for promoting small enterprise is to support regional economic balance, small enterprise is often more concentrated geographically than large enterprise.

Clear cases of regional policy bias occur when particular regions are dominated by ethnic groups that are politically disfavored (e.g., Ibos in Nigeria). Microentrepreneurs in these areas might find it hard to operate their businesses profitably (e.g., because of inferior infrastructure) and would probably not be offered loans by any ME program with official sponsorship. ME programs in many countries have had as one of their major objectives assisting "indigenous"

entrepreneurs to compete more successfully against competitors from entrepreneurial minorities of immigrant origin. Such programs have generally not been very successful at overcoming the informal advantages of the entrepreneurial minorities that were discussed earlier.

In some national economies, especially those in which markets are less fully integrated, the opportunities open to microentrepreneurs in different regions of the country may vary considerably, necessitating different business strategies and tending to bring about different outcomes. In a study of MSEs operating in the Lagos and Ibadan areas of Nigeria, Anheier found that key aspects of firm behavior (their age, size, income and integration in the local economy) were more closely related to geographic location than to the industry in which the enterprises operated (either wood-processing or metal-working). (Anheier 1992) He interpreted this result as strongly indicative of the importance of differences in the local environment for MSE operations and success, as well as evidence of the economic interrelatedness of the "informal" and "formal" sectors.

IV. MAGNITUDE OF ENVIRONMENTAL IMPACTS

A considerable number of environmental effects, including varied forms of policy and regulatory bias as well as aspects of the physical, civic, social, and economic environment, have been identified and discussed as factors that contribute to the success or failure of ME programs, working either directly on the programs themselves or indirectly as influences on program clients, making them more or less successful in business and more or less willing and able to repay their loans. But what is the overall magnitude of these effects? Do they, at one possible extreme, doom microentrepreneurs, and thus ME support programs, to failure, at least in some instances? Or are they really comparatively minor in the end, permitting ME programs can operate in almost any environment? In other words, do environmental effects have to be taken into account by those wishing to evaluate the financial performance and socioeconomic impact of these programs? If so, how? Or can they be effectively ignored?

The available evidence is too sparse and mixed to support a categorical response to these questions. There is some consensus about the direct effect of policy and other environmental influences on ME program operations, but less on the indirect effects. In this section we will deal first with the direct effects and then with the indirect effects on ME programs. In both cases, the discussion is limited to effects on ME program lending; possible effects on any training, technical assistance or infrastructure provision activities that ME programs may undertake are not explored.

A. Direct Effects of the Environment on ME Programs

In their widely-read recent paper, Robert Christen, Elisabeth Rhyne, and Robert Vogel are at pains to argue that a well-designed microcredit program can operate successfully in a wide range of environments (Christen, Rhyne and Vogel 1994). Their study compares eleven ME finance programs -- spread out among countries in Asia, Africa, and Latin America -- all of which are widely regarded as successful. Taking outreach and financial sustainability as the criteria of success, this study tried to measure the degree of actual success achieved and identify the main determinants of the relative degrees of success achieved in the respective programs. Its provocative conclusion was that two key features of program design, the interest rate charged and the average salary paid to staff (expressed as a multiple of GNP per capita) were the principal determinants of the differing degrees of success among these programs. Christen, Rhyne and Vogel strongly suggest that the environment in which a microfinance program operates matters much less than the design of the program itself. They note that the programs they studied were implemented in a wide range of economic environments. In terms of income level, they ranged from extreme poverty to relative affluence (the countries in which the programs were implemented had per capita GDPs that ran from \$220 to \$1,960). In terms of rates of economic growth, the variation was from very slow (0.4 percent) to rapid (7.9 percent). In terms of inflation, the countries ran from complete price stability to 47 percent annual inflation. While some adaptation to the local environment was clearly required, the most successful programs found ways to make that adaptation. In the authors' own words,

The study shows that the most important things government can do to support the growth

of microfinance are: 1) to maintain low inflation, or at least stable inflation; and 2) to allow programs to charge the interest rates and fees needed to cover all costs and accommodate inflation. For donors, the most important conclusions are: 1) that microenterprise finance can operate successfully in a wide range of conditions (though it is assumed that hyperinflation is an exception), and 2) the status of financial sector development can affect the growth path of microfinance institutions. (Christen, Rhyne, and Vogel 1994, 41).

It should be noted that this conclusion comes out of a study that focused on the effect of program design on program performance and not on the effect of program environment as such. While it is true that the study included programs located on three continents, it must also be recalled that this was a "best practice" study which was purposely limited to programs that were generally regarded as successful. While the conclusion that relatively successful ME lending programs can be mounted in Africa, Latin America and Asia is encouraging, it does not mean that all environments are equally welcoming to such programs, even when they are well designed. It seems clear, for example, that the average performance of ME lending programs has been lower in Africa than in Asia or Latin America (cf. Webster 1991, which shows that World Bank-supported microlending projects in Africa had an average repayment rate of 60 percent). While this difference may be attributable in part to inferior program design in Africa, it is also likely to owe a lot to the existence of greater challenges in the operating environment. Even among the eleven "best practice" programs covered by Christen, Rhyne, and Vogel, three have recently been reported to have experienced serious financial difficulties.

The Christen-Rhyne-Vogel paper in fact makes it clear that at least two types of government policies can block the realization of an effective program design for ME lending:

1. Policies that prevent programs from setting interest rates high enough to cover their costs. It should be noted that the same effect can be achieved by political pressures: a bank in one African country recently suspended its microlending for fear that criticism of the high but legal interest rate that it was charging small-scale borrowers would hurt its other banking business.
2. Policies that force lenders to pay wages that are far above the opportunity cost of labor in the country. This can come about, for instance, when the lending program is run by a government institution and its employees are able to press their case for civil service pay and benefit standards.

The only other concession to environmental difficulty made by Christen, Rhyne, and Vogel is hyperinflation, which can quickly decapitalize the lending program if it is not anticipated and incorporated into loan contracts. It is also plausible, however, to add that problems with property law administration can cause problems when collateral is used, and also that overly restrictive limitations on deposit-taking make it hard for lending institutions to build up their capital. These are additional examples of how the legal and regulatory environment can impinge on lenders' ability to develop an effective microfinance program.

B. Environmental Factors that Affect ME Programs through their Effects

on Microenterprises

Getting a sense of the magnitude of environmental factors that work indirectly via their effects on client microenterprises is more difficult.

For Hernando de Soto, bureaucratic overregulation of business is a major factor limiting economic development and forcing many existing **Ainformal** (and usually small, but sometimes large) businesses to operate informally as **Alegal** activities carried out in an illegal manner.[@] As a telling example of the impact of regulatory complication, de Soto's Institute for Liberty and Democracy documented the thousands of dollars and months of time that were required to establish small legal businesses in Peru (de Soto 1989, 131-187). Later, they repeated the experiment in Miami, where far smaller amounts of time and money were required to complete the same process.

The strong impression left by de Soto's analysis is that overregulation severely impedes capitalist enterprise, at least in Latin America, and forces many businesses to operate at a high level of risk in a semi-legal **Ainformal** sector.[@] It is hard to believe that the kinds of regulatory problems that de Soto documents in such detail for the Peruvian environment would not create serious problems for even the best-run microfinance program.

Many surveys of microentrepreneurs, however, suggest that government regulation is not one of their most challenging business problems. Although perhaps naive, the most common methodology for determining which constraints are most binding on microentrepreneurs is to ask them directly in a sample survey. Many such studies have been carried out. One recent survey, by Christian Morrisson, Henri-Bernard Solignac Lecomte, and Xavier Oudin, surveyed seven developing countries (two in North Africa, two in Sub-Saharan Africa, and one each in the Caribbean, Latin America and Asia) in an effort to test what they characterized as the neoliberal thesis that the regulations and administrative practices of the state are "the prime cause of stagnation of the informal sector." (Morrisson, Lecomte, and Oudin 1994) Their study covered microentrepreneurs in the same five sectors (textiles, metalworking, woodworking, restaurants, and mechanical repairs) in all seven countries. The researchers found that most of the microenterprises covered paid some taxes and were not, in that sense, "informal," although they might not be registered. The main finding of the study was that the microentrepreneurs surveyed did not, in general, cite regulatory constraints as one of the four most important problems faced by their businesses. Lack of financial resources was constantly mentioned as a prevalent difficulty, as in many other similar surveys. In the poorest countries in the survey, the weakness of demand for ME products was frequently cited as a problem. In the richest country in the sample (Thailand), entrepreneurs complained about shortages of skilled labor.

When microentrepreneurs did mention policy and regulatory constraints in the Morrisson et al. study, the two types of problem that were widely complained of were taxation and siting restrictions. The level of taxation was frequently bemoaned in Niger and Swaziland, where the microentrepreneurs were very poor and the tax system reached down to their level. Complaints about taxation were also frequent in Algeria and Thailand, richer countries where tax rates were higher. Restrictions on location were common in these four countries and also in Tunisia. Other

types of regulation, such as health and safety regulations or labor legislation, were seldom mentioned in any of the countries surveyed.

Many other studies have tried to determine which environmental impacts most severely restrict the activities of microenterpreneurs, and which among these impacts constitute the most tightly binding constraints. William F. Steel and Leila Webster, for example, surveyed 300 enterprises of various sizes in Ghana in 1988. Out of this sample, only 52 percent said they had major regulatory problems of any kind. Moreover, the percentage of respondents reporting such problems was far higher (82 percent) for medium and large enterprises than for microenterprises (44 percent) (Steel and Webster 1990, 35). Medium and large firms reported a wide range of regulatory problems (employment regulations, price controls, the investment code, licensing and the minimum wage law), while microenterprises complained about only two specific problems: restrictions on location (mentioned by 25 percent of respondents) and registration requirements (mentioned by 31 percent). Taxes, which 30 percent of medium and large businesses cited as a major problem, were mentioned by only nine percent of microenterprises. Based on this evidence, Ghana would appear to be a country where microenterprises can escape many government impositions, although they do have to worry about two regulatory concerns common to microenterprises in other developing countries.

Similarly, Ralph Bradburd and Brian Levy found that fewer than five percent of the black business people whom they interviewed in Zimbabwe in 1994 reported large or severe problems associated with government controls on business (Bradburd and Levy 1996). This situation may have resulted from the economic structural adjustment program launched in 1990.

"Prior to the ESAP (Economic Structural Adjustment Program), Zimbabwe was a tightly controlled economy. Foreign exchange was rationed; firms required licenses to undertake new investments; price controls were pervasive; labor regulations were rigid; entry regulations were restrictive. One of the primary objectives of the EASP was to eliminate these controls. Both the present survey, and the results of larger surveys undertaken under the auspices of the World Bank-sponsored Regional Program on Enterprise Development, suggest that this objective has been achieved." (Bradburd and Levy 1996, 17-18)

In the deregulated economy, most of the problems reported by black entrepreneurs -- and all those that large numbers of them considered large or severe -- were related to the economic environment. They included high interest rates on finance, the high cost of raw materials, limited access to finance, the unavailability of trade credit, the high level of utility charges, and the low quality of infrastructure. Political uncertainty ranked far down the list of business problems and government control of business ranked dead last. (What would have been the result if white-owned firms had been surveyed, the authors do not speculate.)

Recent findings for Niger and Swaziland are reported by Michael A. McPherson and Carl Liedholm (1996). They found that while virtually all nonagricultural firms in those two countries were required to register with some level of government, sizeable numbers were not, in fact, registered. While most urban enterprises in both countries did register, very few rural firms did so.

Most of those who did not register were unaware that they were required to do so. Fewer than 20 percent wished to register but found the registration process too complicated or costly. The low level of firm registration is somewhat hard to understand, since the national and local governments in both countries had significant incentives (ease of tax collection, enforcement of labor regulations, health and sanitary regulations) to register all firms and the firms themselves had some good reasons to comply (only registered firms may obtain credit from banks, participate in government-sponsored training programs, obtain foreign exchange, or advertise their products). Yet many firms remain unregistered. Evidently, the incentives for registration are not compelling for those firms (mostly small and/or rural) that do not register, while certain classes of enterprise (those in rural areas, home production, and producers in certain less-regulated industries) appear to have escaped the enforcers' notice. Patterns of under-registration were similar in the two countries, despite differences in their regulatory systems.

While these and other studies found government regulatory efforts not to be a major inhibitory force for microenterprise, deGroot reached a contrary conclusion for Kenya (Barbara deGroot 1990). She observed that local authorities in that country have extensive powers to regulate microenterprise and use these powers in ways that are inimical to the national government's announced policy of promoting MSEs. The Local Government Act of 1978 gave local governments extensive authority over small business. They can:

AControl public sales of and places of any sales and license persons to conduct such sales...charge fees, without restriction on amount, for any business license issued...prohibit and control shops in rural areas...control all establishments where articles of food or drink are manufactured, prepared for sale or use, stored, or sold...prohibit or control peddling, hawking, street trading, barkers, second-hand goods dealers, and trades and industries deemed to be noxious or offensive...refuse to grant and to cancel business licenses...[and] make adoptive by-laws under the Local Government Act and other laws of Kenya, including the Building Code and the Public Health Act.@(deGroot 1990, 8-9)

DeGroot found that these powers were exercised to the detriment of MSEs. Restrictive numerical limits on the issuance of hawkers' licenses force most small traders to operate illegally. Moreover, with the deterioration of other revenue sources, license fees have become an important source of funding for local governments. While the national government's policy calls for a reduction in fees levied on small businesses, such fees have in fact increased. DeGroot claims that these fees have also been used to discourage certain types of small business, but she does not comment on the inherent inconsistency between the revenue objective and this protectionist motive. **A**In summary,@she says,

AThe local government regulatory framework in many ways is inconsistent with the GOK's newly positive policy of supporting and encouraging the growth of informal sector business. There is little evidence of widespread implementation by local governments of the regulatory reform called for in Sessional Paper No. 1 and the National Development Plan. By-law provisions, licensing requirements regarding the number and location of informal businesses, licensing fee levies, building requirements, and general regulatory enforcement methods in place at the local government level frequently conflict with the

informal sector support objectives outlined in these documents. (deGroot 1990, 12)

What can we conclude from these scattered survey results? In countries that have deregulated their economies, the policy and regulatory bias against MSEs has been reduced and microfinance programs should enjoy considerable scope to work effectively on the problem that microentrepreneurs complain about most frequently: access to finance. In countries that remain more highly regulated, policy constraints are likely to be more binding, but even there we have seen that they do not feature prominently in most microentrepreneurs' accounts of their business challenges. Nevertheless, significant policy and regulatory biases against microenterprises, the poor, rural areas, women and groups that are disfavored by the political system may exist in particular circumstances. And even where policy and regulatory restraints are not tight, other environmental factors remain influential in helping to determine the performance of microenterprises and thus of ME programs.

The final question to be addressed in this paper is what account should be taken of environmental effects by those who seek to measure the socioeconomic impact of ME programs.

V. ACCOUNTING FOR ENVIRONMENTAL EFFECTS IN PROGRAM IMPACT EVALUATIONS

We have seen that while the necessary conditions for establishing a sustainable microfinance program are now pretty well defined, the discussion about the possible effects of many other environmental factors, especially those that impact ME programs indirectly through their effects on client enterprises and their associated households and communities, remains inconclusive. For this reason, one cannot define with any certainty a scheme for insuring that differences in environmental influences do not complicate program impact evaluations. The most that would seem possible on the basis of the preceding discussion are the following generalizations.

1. There appears no strong basis for believing that sustainable ME programs cannot be developed in countries with a wide range of characteristics as long as financial and other regulations permit such programs to be implemented. While one would expect a higher degree of success from a given type of program in countries with higher levels of income, higher rates of economic growth, and higher population density, it is not clear how decisive these environmental variations really are.
2. Evaluators should nevertheless be sensitive to all the possibilities of environmental difference (and change over time) described in this paper. Each AIMS core impact assessment should include a thoughtful discussion of the environmental factors that might affect program performance, either directly or indirectly.
3. Although the core impact assessments under the AIMS project are in principle limited to sustainable programs, it may be difficult, especially in the early stages of program development, to determine whether a program is truly sustainable. Accordingly, evaluators should check to make sure that financial and other regulations permit a truly sustainable program to be operated. This includes freedom to set interest rates, adequate but not oppressive prudential regulation, the right to accept voluntary deposits, and the absence of regulations that require excessive wages and benefits to be paid to program staff. Failure to meet these conditions will make it difficult or even impossible to establish a viable program.
4. The occurrence of an environmental catastrophe -- a flood, major drought, earthquake, volcanic eruption, riots or other forms of civil disturbance -- would obviously contaminate a program evaluation.
5. While most surveys suggest that government policies and regulations do not, in fact, pose a major obstacle to the operation of microenterprises, the possibility that policies and regulations biased against microenterprises, the poor, rural areas, women, particular social groups, etc. could make it hard for clients to earn income and thus repay their debts should be carefully considered. It should be remembered that what counts is the effective application of the system -- its enforcement -- not what is written in the legal code of the country concerned.

6. Particular sensitivity is required to local government actions that might impede microenterprise activities. This could derive either from tax and regulatory powers delegated to local governments under a federal or decentralized system or from local variations in enforcement of policies and regulations that are supposed to be uniform across the country.
7. Hyperinflation (say inflation of 100 percent per year or more) should be regarded as a major threat to microenterprise programs, even though adjustments can in principle be made with some experience, particularly if the approximate rate of inflation is anticipated.
8. In comparing program and comparison groups for purposes of impact evaluation, reasonable care should be taken to see that the two groups are similar with respect to key features of the program environment. The discussion in this paper has been unable to determine which factors are critical, but it has indicated that major differences in population density, mean income level, degree of urbanization, gender, ethnicity, the structure of goods and credit markets, and government policy, regulatory, and enforcement patterns should be avoided.

VI. CONCLUSIONS

A very wide range of environmental influences can affect the outcome of ME programs, working either directly through the operation of the program itself or indirectly through the prosperity and business prospects of the client enterprises and the households and communities with which they are associated. While it is easy to see that physical, institutional, economic, and policy and regulatory factors can all have some effect, the everyday workings of these factors (as opposed to occasional catastrophes, which have more dramatic effects) are in many cases hard to trace completely, let alone to quantify. ME program impact evaluators should be aware of the potential influence of environmental factors on program outcomes and should design with/without comparative analyses to avoid large differences in any of the more obvious ones.

Government policies and regulations have an important direct influence on sustainable microfinance programs, since freedom to set interest rates is vital to sustainability. The right to accept voluntary deposits and avoidance of cost-increasing labor regulations are also important. The effect of policies and regulations on the microenterprises themselves is less clear-cut. Although it has been argued that over-regulation is a major impediment to business development in many developing countries, most surveys indicate that microentrepreneurs do not regard taxation and regulation as among their major business problems.

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